Economic Outlook
Engines of Growth During Malaise
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Please read the important disclosure information in the Addendum section of this presentation.

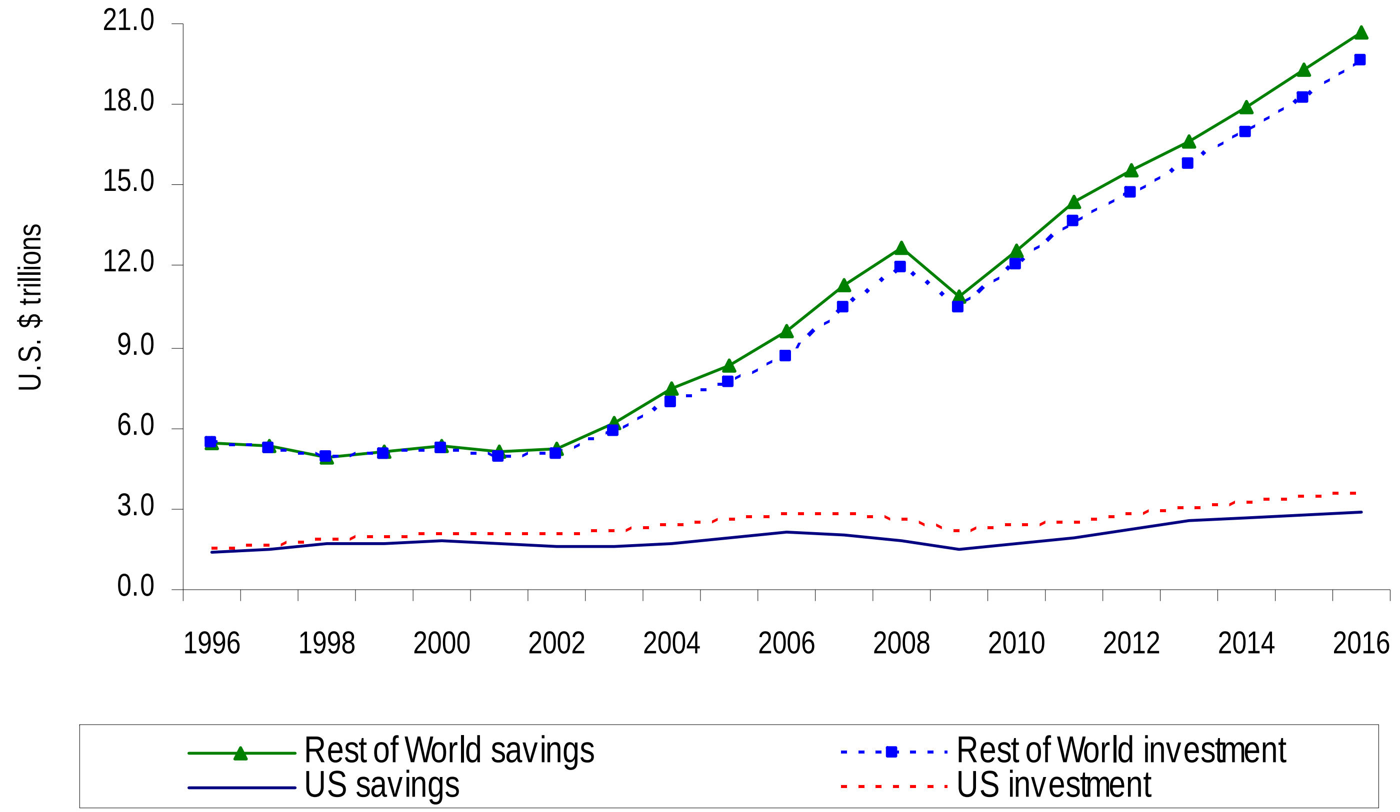
Transformations

Elephant-sized structural reforms are transforming globe

- **Creation of sound money like euro, yuan, real, rupee, T-lira; ten-year local currency bonds**
- **Internet; information for farmers, geneticists, innovators; Google, Facebook**
- **Privatizations like Petrobras; ownership of trucking, telecom**
- **Personal retirement accounts and defined contribution plans**
- **Private property and title to it**
- **Long local currency yield curves and entry of foreign banks are allowing globalization of financial intermediation**
- **Market-based pricing – still more to go**
- **In the U.S., state-driven structural reforms -- privatizations, tort reform, defined contribution plans**

Investment Outside U.S. Growing Fast

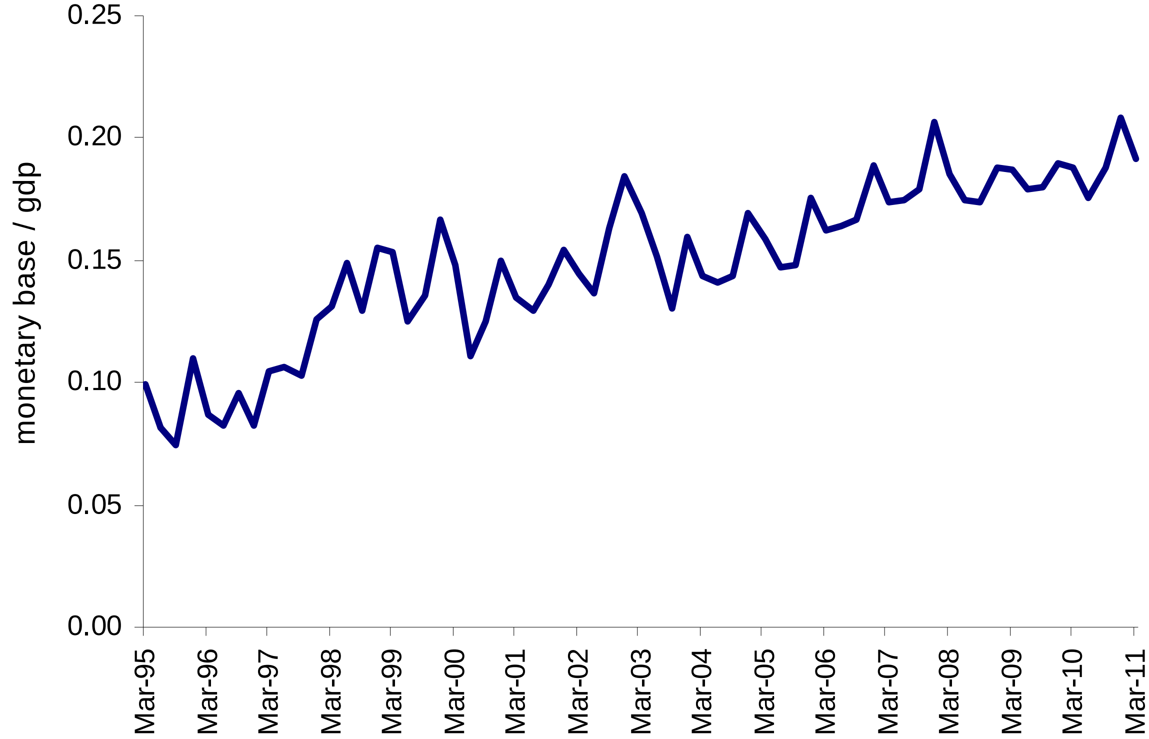
(last obs. Q1 2011)



Source: IMF; Encima Global

Brazil Added $90B to Monetary Base

($18.1 billion in 1995, $108.0 billion in 2011, last obs. Q1 2011)

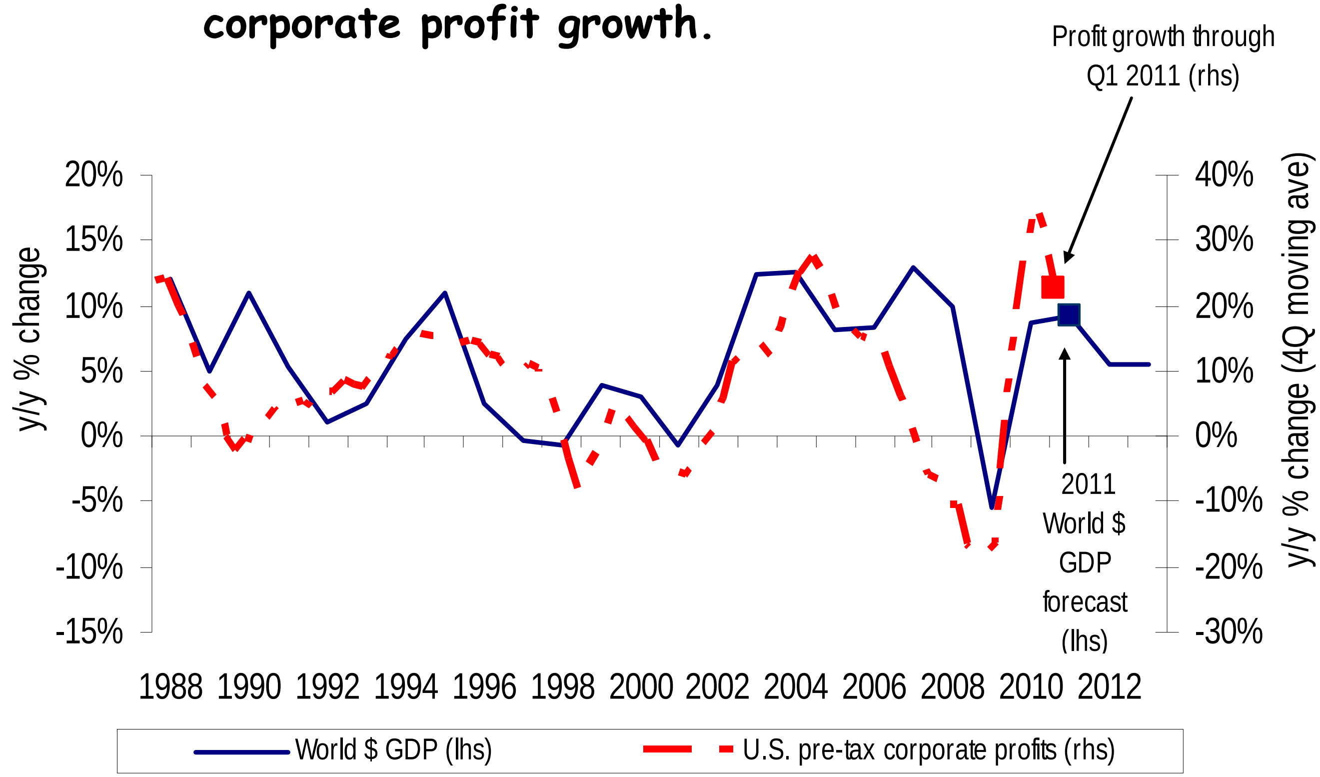


Source: Bloomberg; Encima Global

U.S. Corporate Profit Growth and World $ GDP

(last obs. Q1 2011 for NIPA corporate profits, IMF forecasts for $ GDP to 2013)

Strong growth in world $ GDP supporting U.S. corporate profit growth.



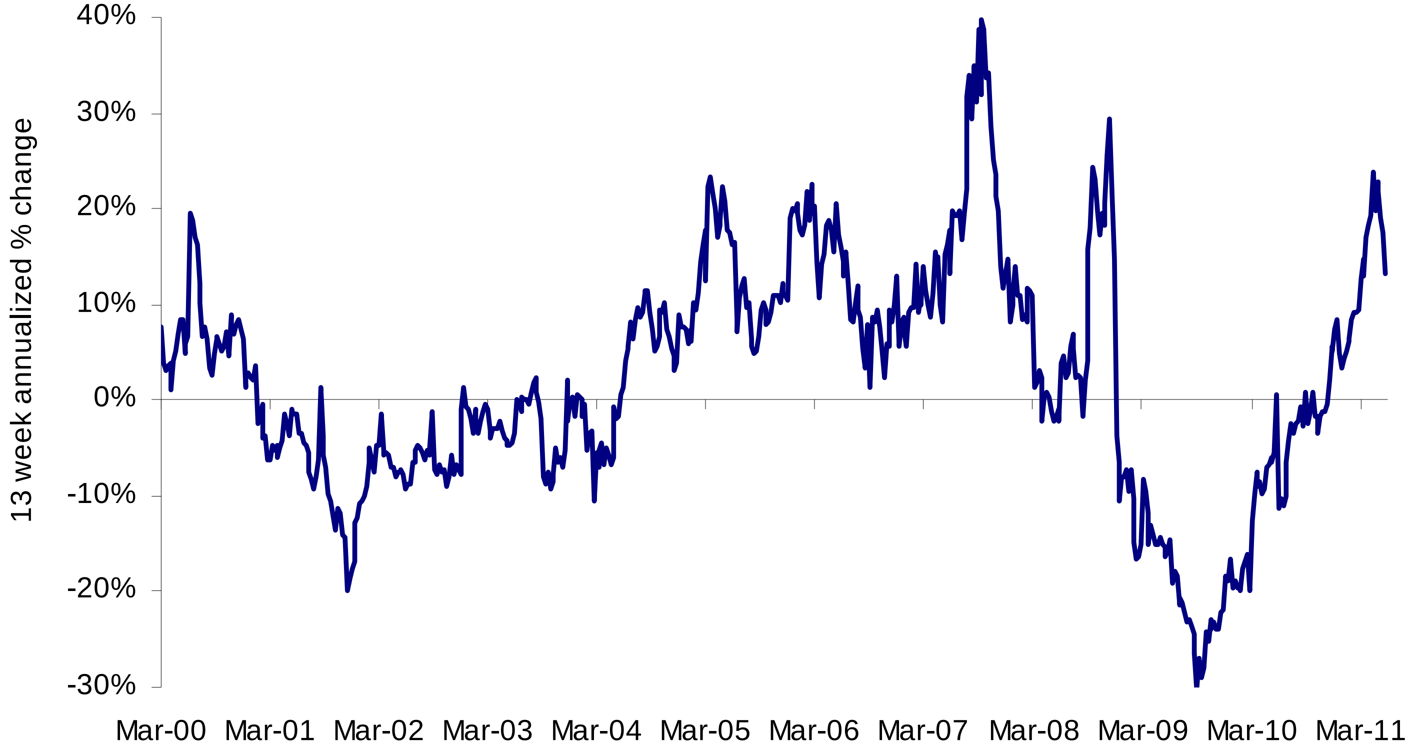
Source: Bureau of Economic Analysis; IMF; Encima Global

Engines of Growth

- **We expect U.S. growth to accelerate to 3.5% in the second half, causing a global shift from bonds to stocks as it comes into view. Faster growth is based on increased auto production, corporate profits and top line sales growth, some job growth, and pent-up demand for business investment, personal consumption and, in 2012, housing in many parts of the country.**
- **China's consumption is growing rapidly. U.S. export growth is strong -- emerging markets are enjoying rising living standards and strong capital investment, partly from U.S. capital flight. U.S. corporate earnings growth should remain strong, helped by non-U.S. profits, now nearly 25% of total U.S. corporate profits.**
- **U.S. bank lending is finally rising -- at a 9.4% annualized rate over the last 13 weeks with M2 growth accelerating to 7.8% annualized in the same period.**

Large Banks C&I Loans

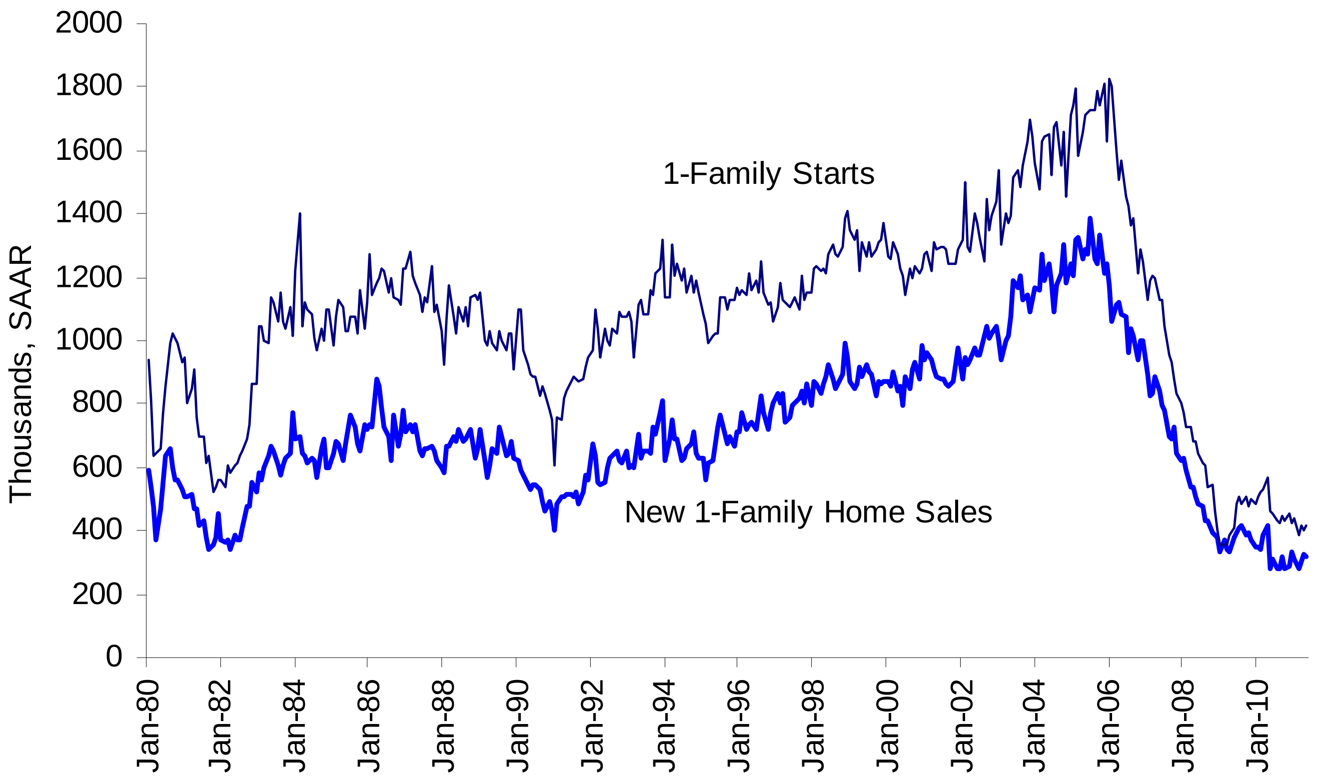
(13 wk change annualized, last obs. June 22, 2011)



Source: Federal Reserve: Encima Global

Housing Starts Too Slow For Population

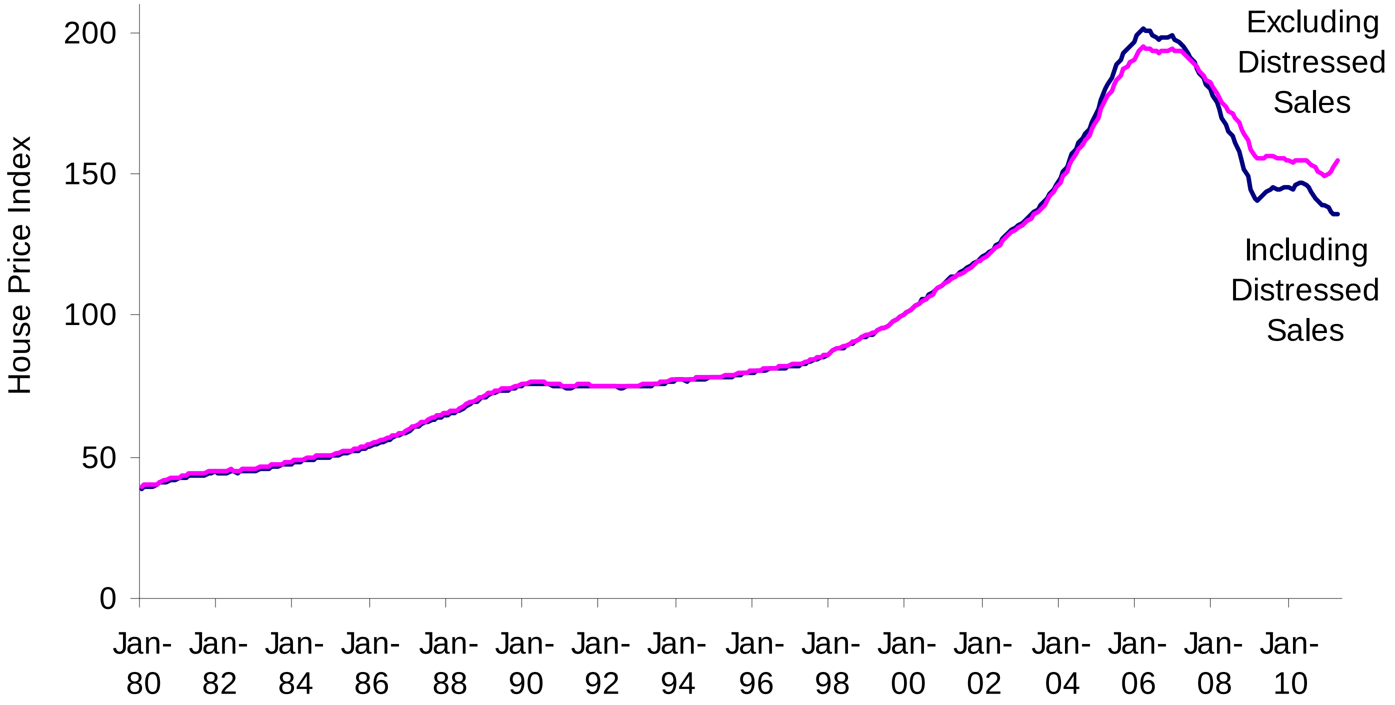
(last obs. May 2011)



Source: Census Bureau; Encima Global

Non-Distressed Home Prices Turning Up

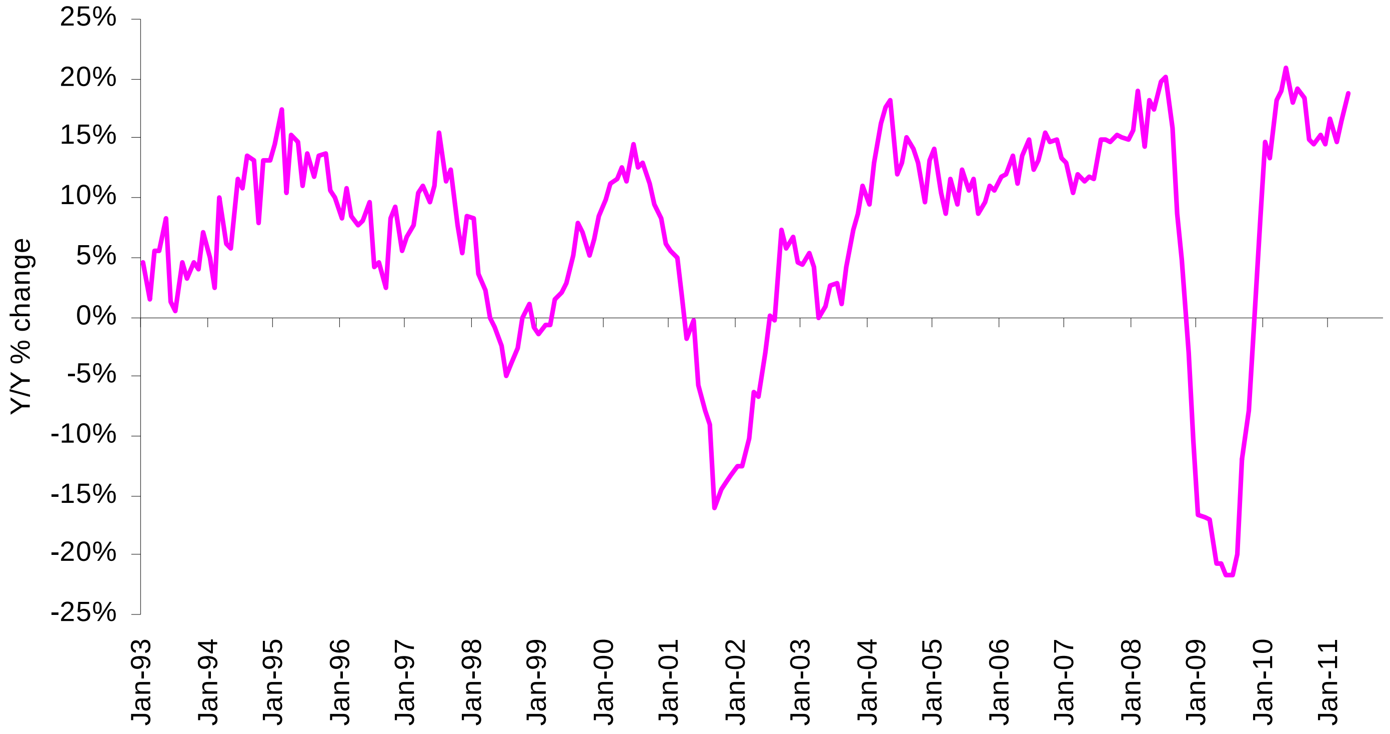
(last obs. May 2011)



Source: CoreLogic; Encima Global

U.S. Export Growth

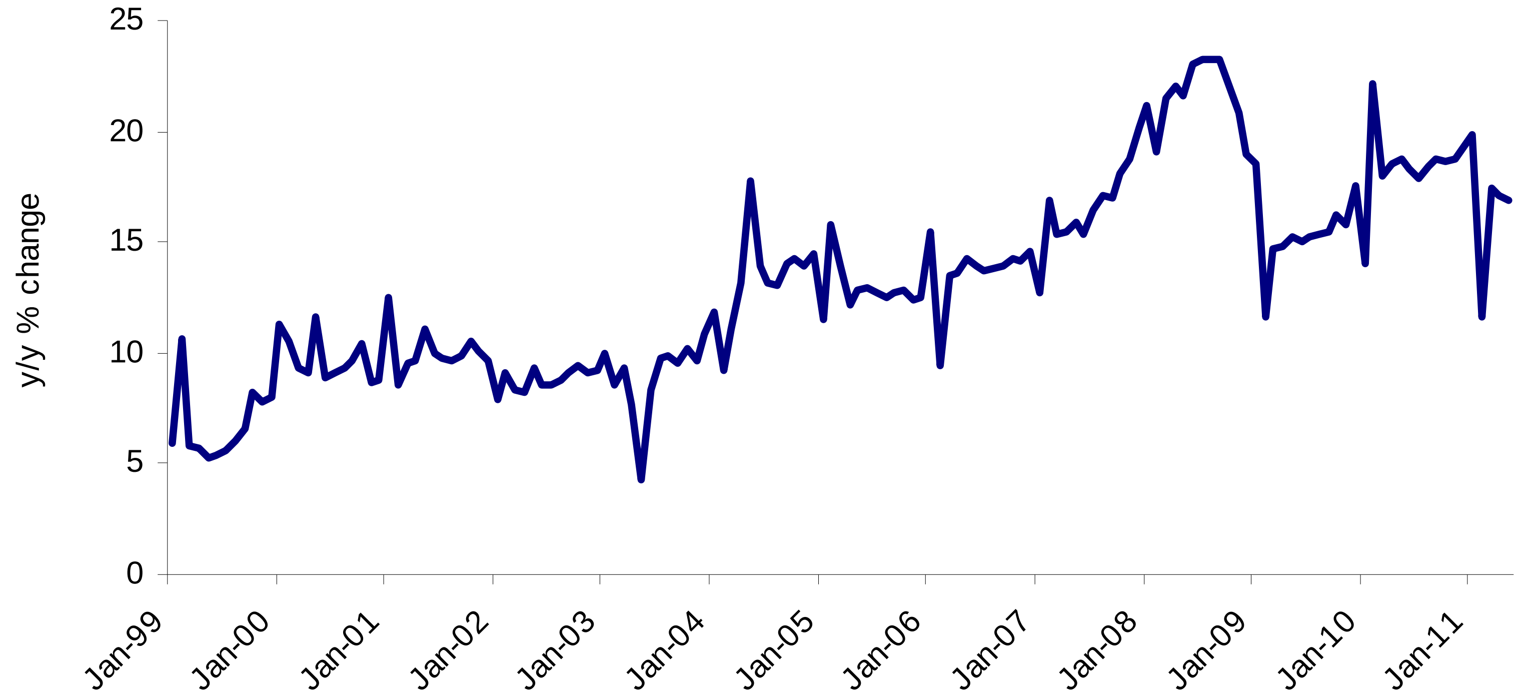
(last obs. April 2011)



Source: Bureau of Census; Encima Global

China's Retail Sales Y/Y

(last obs. May 2011)



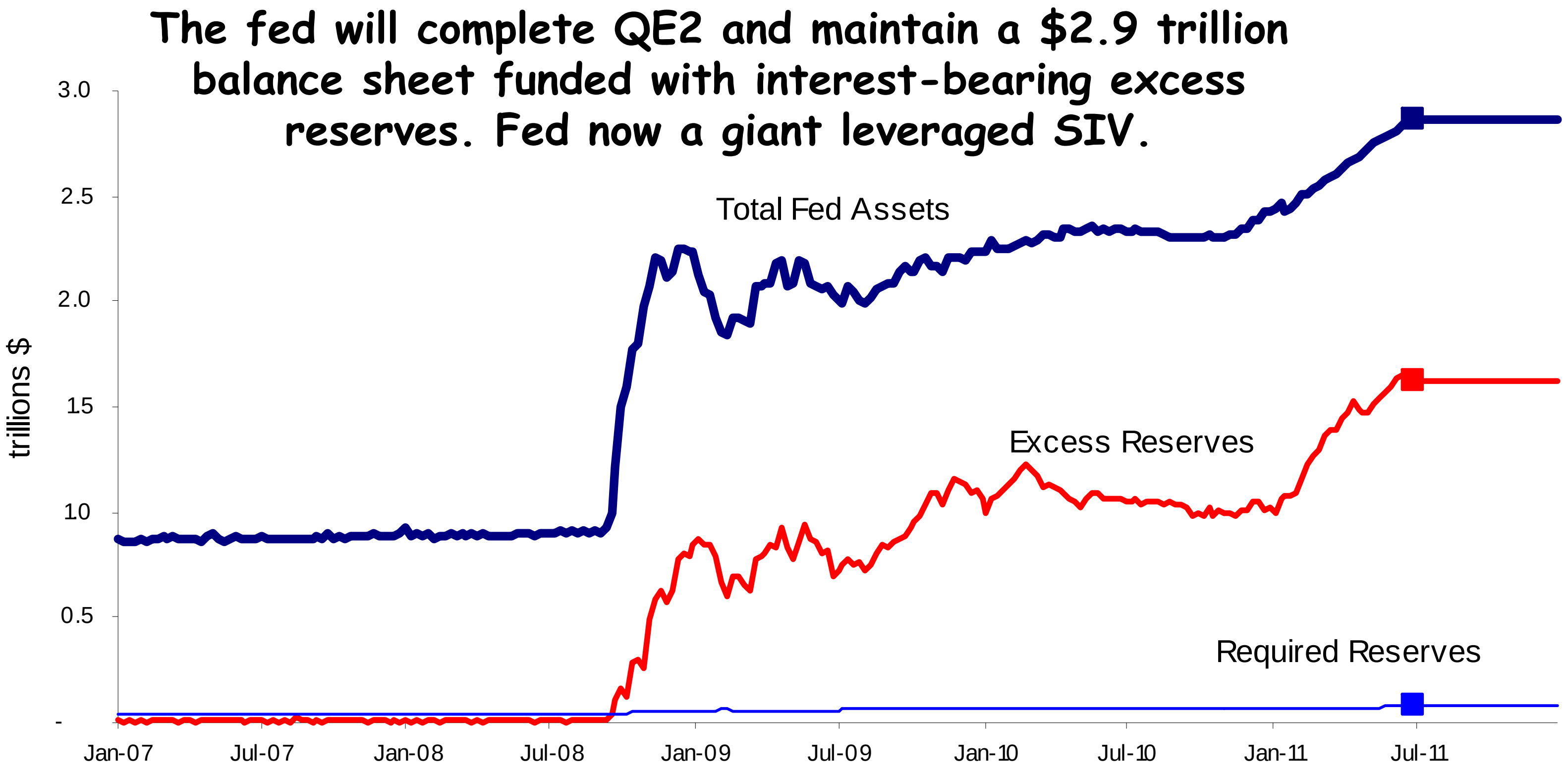
Source: Bloomberg; Encima Global

Evolution of Global Monetary Policy

- **U.S. monetary policy is now primarily based on regulatory rationing of credit rather than price-based allocation. The near-zero Fed funds rate is too low to impact monetary policy and is harmful because it distorts short-term credit markets and subsidizes the government, banks and big corporations at the expense of savers.**
- **The end of QE2 should add to global confidence, creating a sigh of relief that the experiment is finally over. QE2 wasn't money printing. Only excess reserves grew, not private sector credit or M2 money supply. Equities went up mostly due to GDP growth and rising profits. QE2 did weaken the dollar and cause a surge in commodity prices and CPI inflation, but we think those will wash out.**
- **Rather than QE3, we expect regulatory easing in the U.S., allowing existing bank capital to fund more mortgages, commercial loans and securitizations.**
- **With global liquidity now massive, Basel III standards will get lip service but won't stop global loan growth. Many banks will lend aggressively.**

Excess Reserves Rose – Fed 'Pushing on a String'

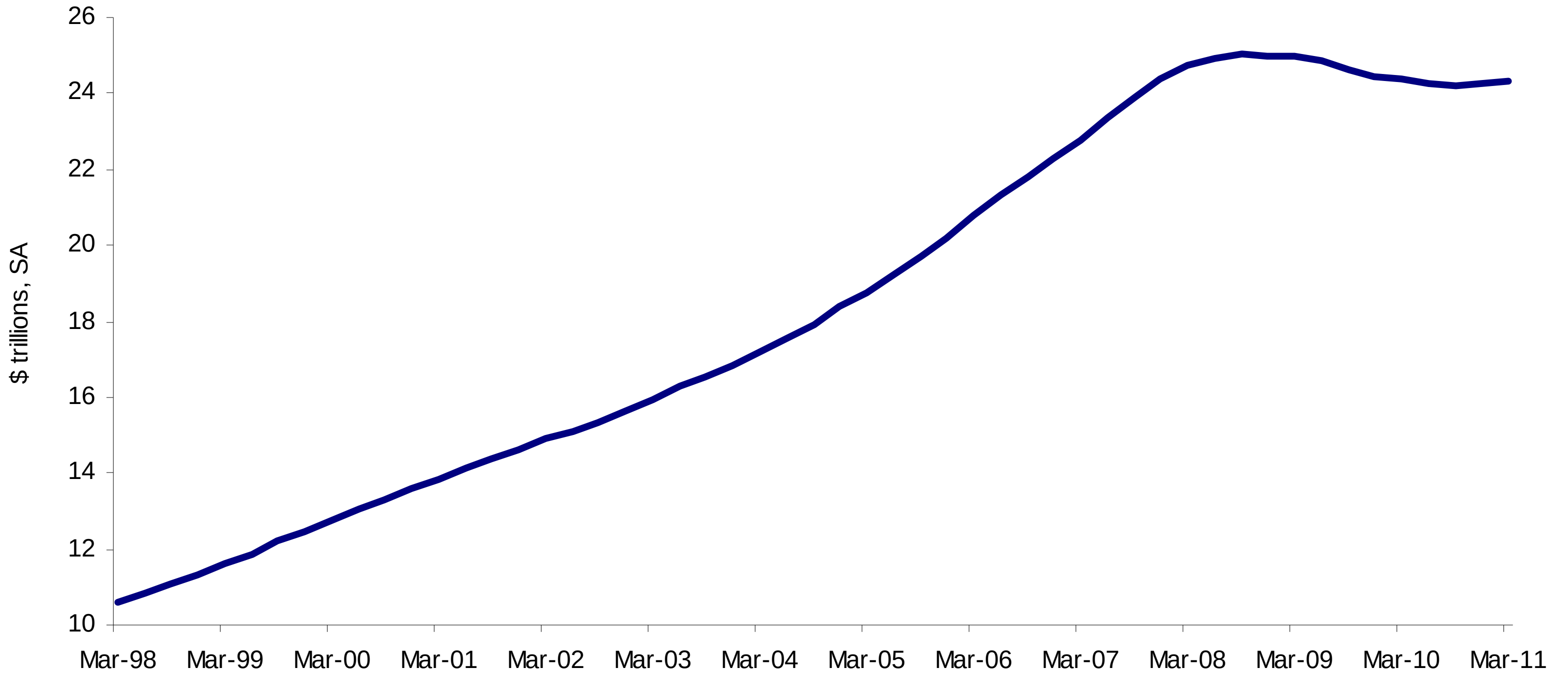
(last obs. June 29, 2011)



Source: Federal Reserve: Encima Global

Little Growth Yet in U.S. Private Sector Credit

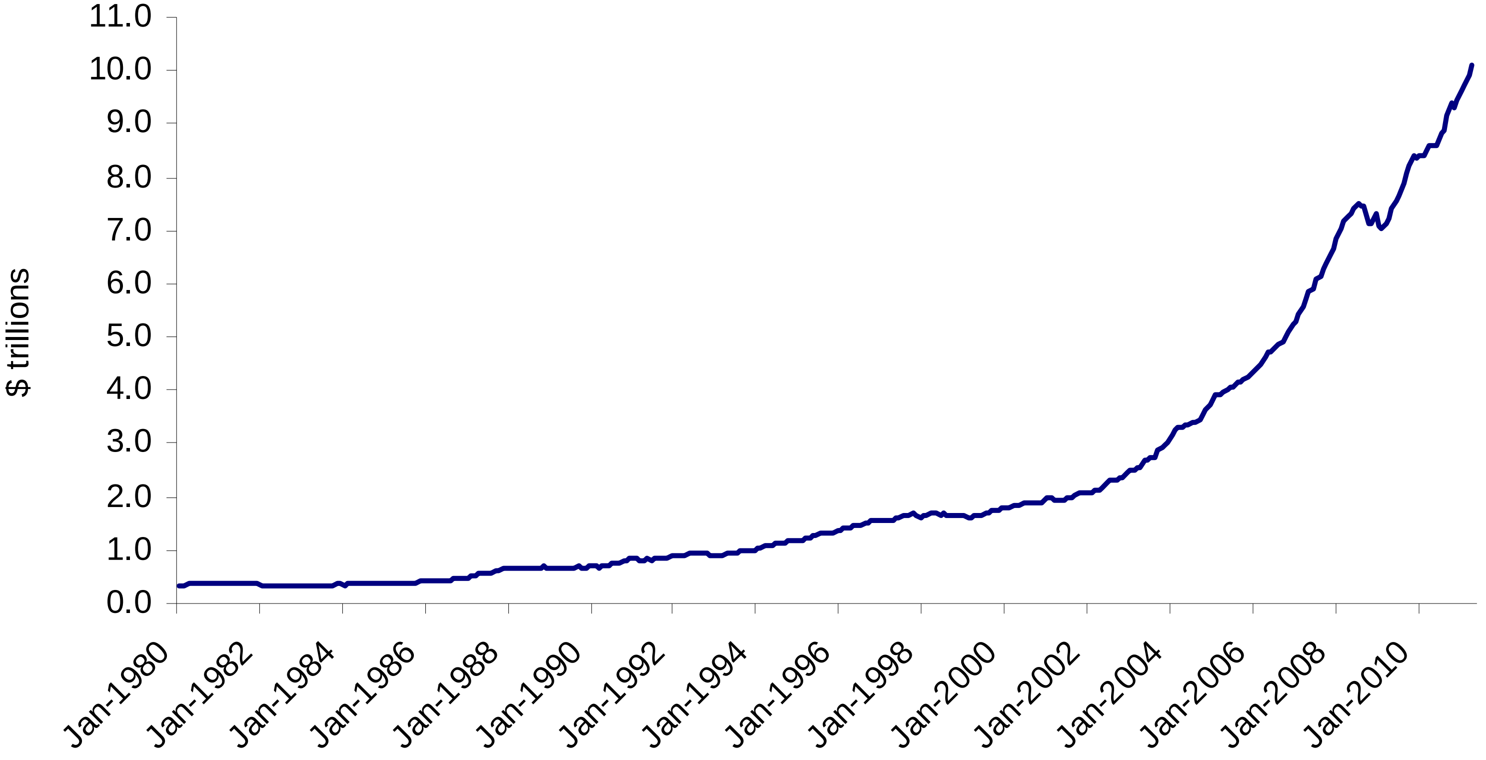
(last obs. Q1 2011)



Source: Federal Reserve; Encima Global

The U.S. Credit Pump: Huge Growth in Global Official Reserves

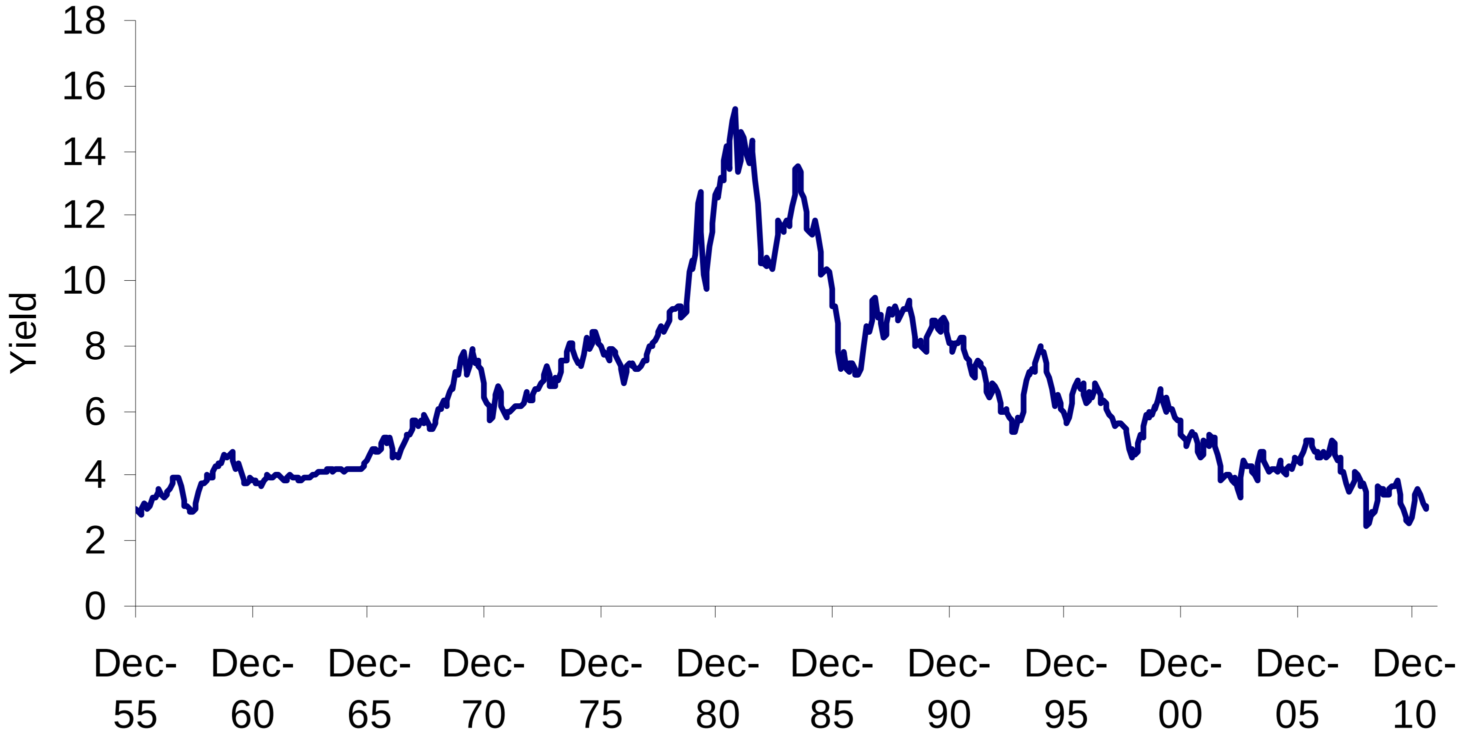
(excludes gold holdings and U.S. reserves; last obs. April 2011)



Source: IMF; Encima Global

10 Year US Treasury Yield

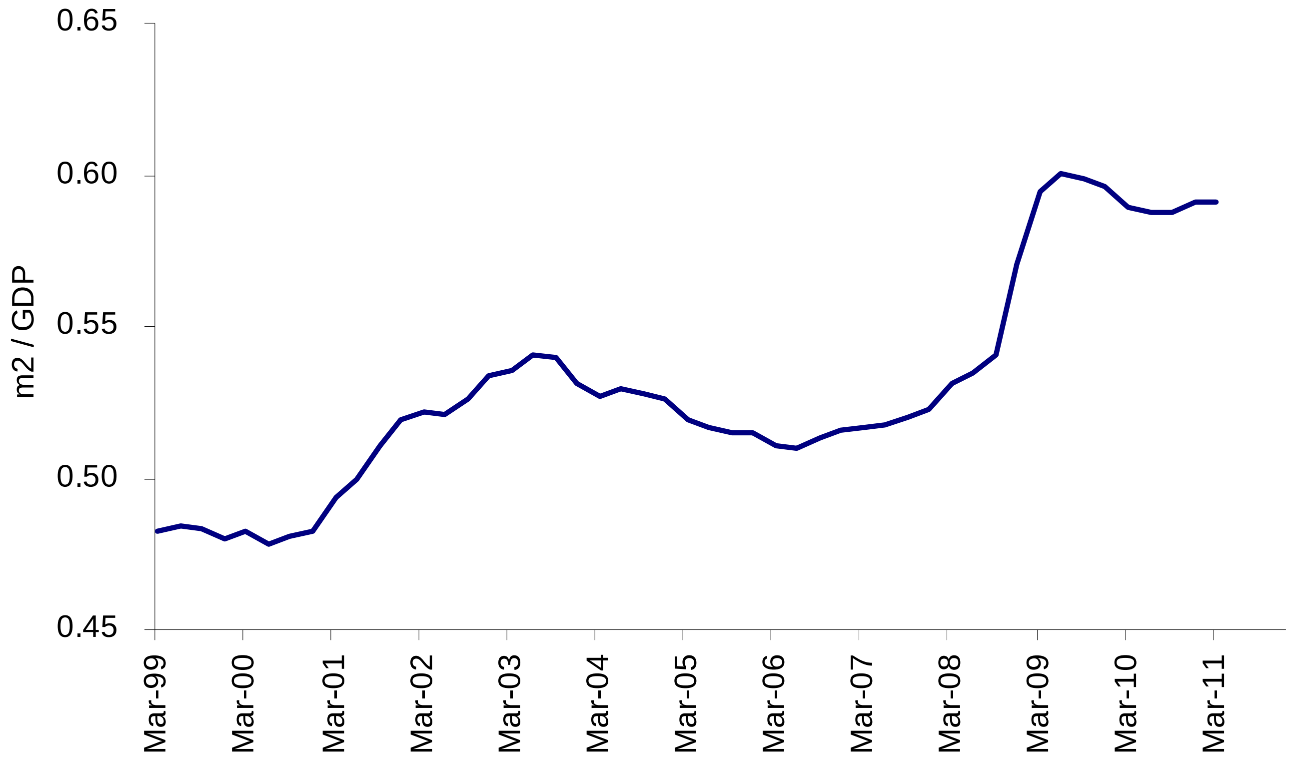
(last obs. July 6, 2011)



Source: Federal Reserve; Encima Global

Regulators Caused Decline in US M2 After '08 Crisis

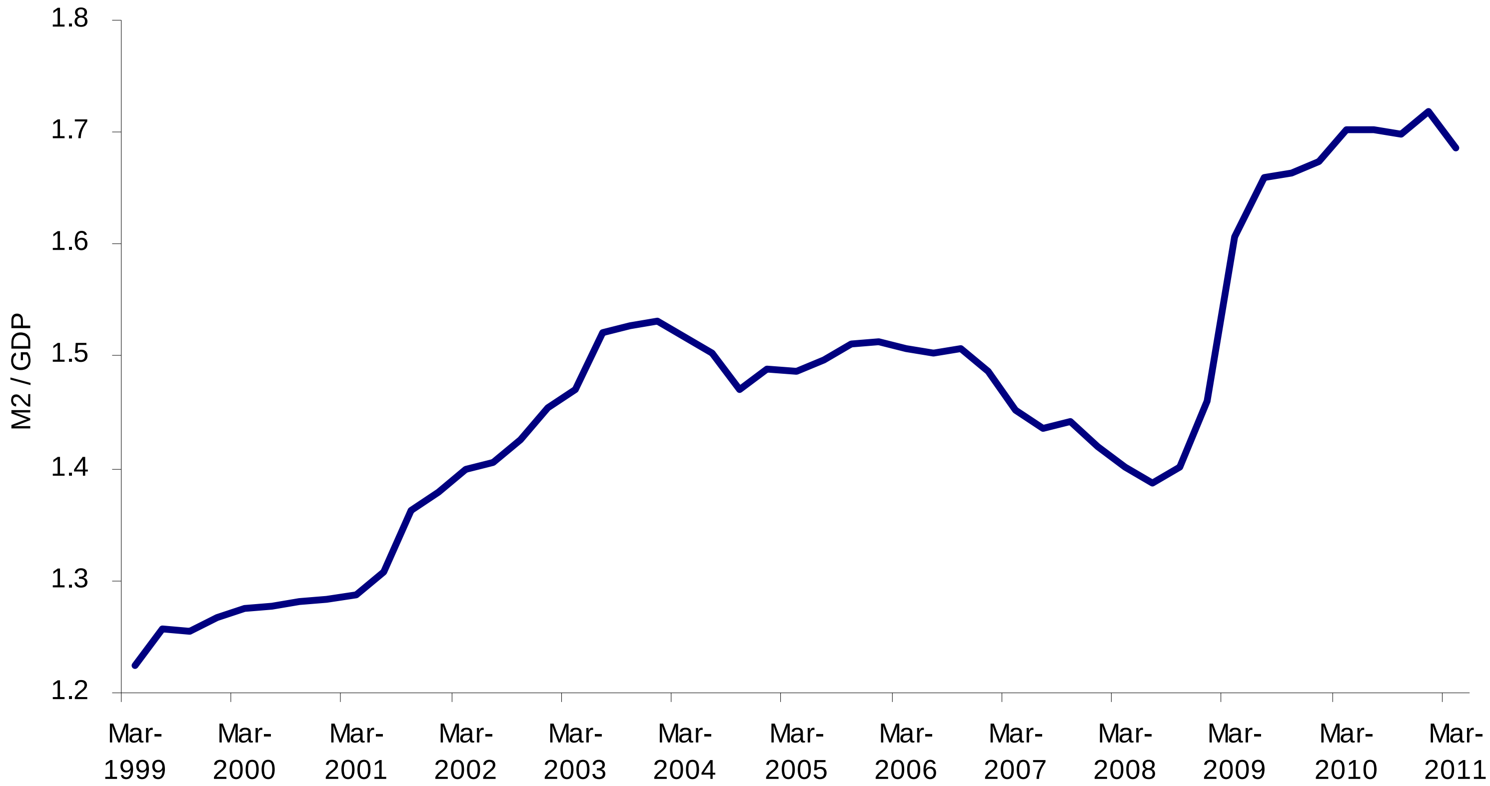
(last obs. Q1 2011)



Source: Federal Reserve; BEA; Encima Global

China's M2 Grew Faster Than GDP After '08 Crisis

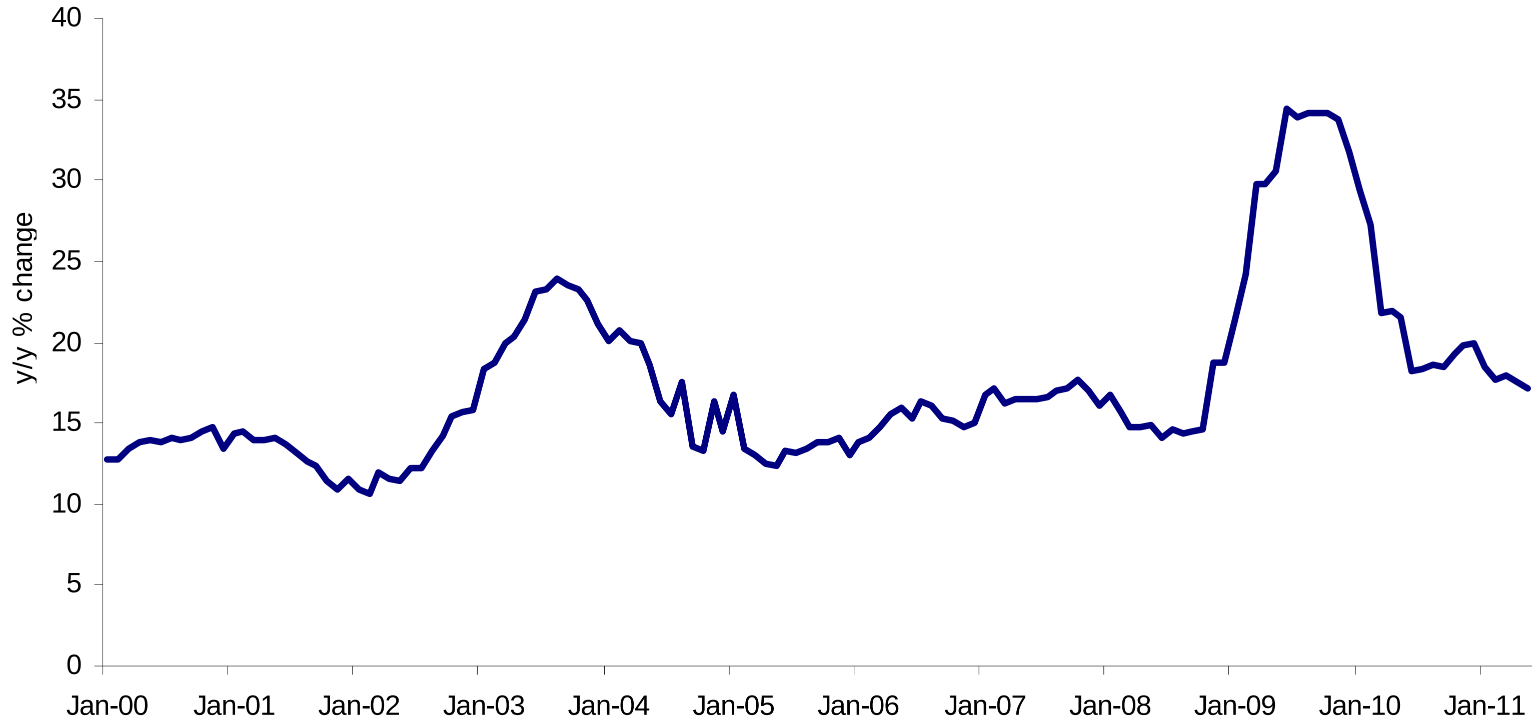
(last obs. Q1 2011)



Source: China National Bureau; People's Bank of China; Encima Global

China's Lending Y/Y

(last obs. May 2011)



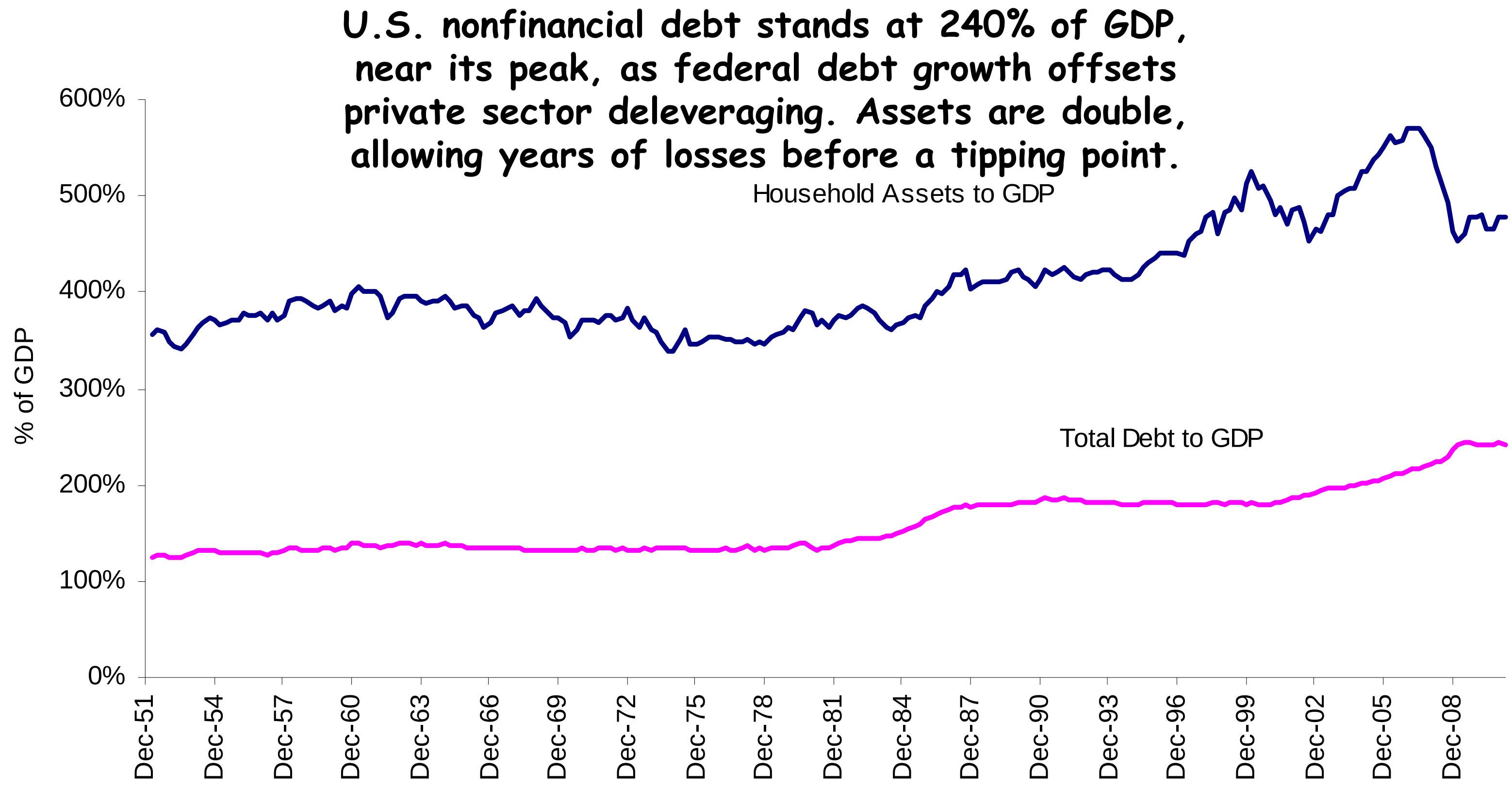
Source: Bloomberg; Encima Global

Climbing the Wall of Worry

- **Several worries are getting resolved including the Japanese production disruption, uncertainty about the end of QE2, and the risk that the Greece debt situation might have triggered a default event and a devastating CDS payout.**
- **The debt limit increase will get done one way or another. A default of any kind including delayed interest payments would have catastrophic consequences, but is highly unlikely and is mostly under discussion as part of the negotiating process.**
- **Ultra-loose fiscal (and monetary) policy are likely to continue. The U.S. doesn't have much structural reform process under way yet, either at the federal level or in many of the states.**

U.S. Household Assets $72 Trillion; Total Debt $36T

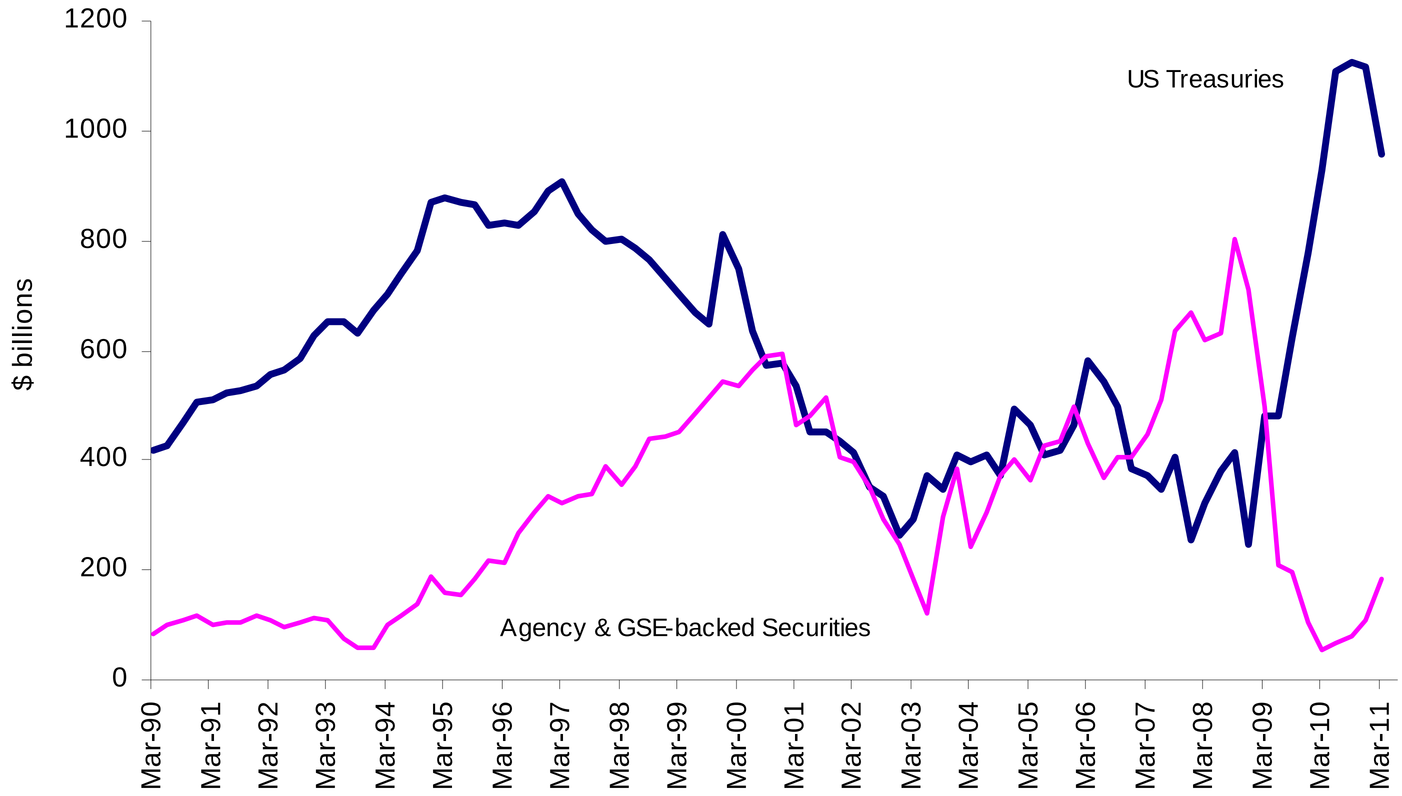
(last obs. Q1 2011)



Source: Federal Reserve; BEA; Encima Global

U.S. Households Adjusted to Fed's QE2 Buying

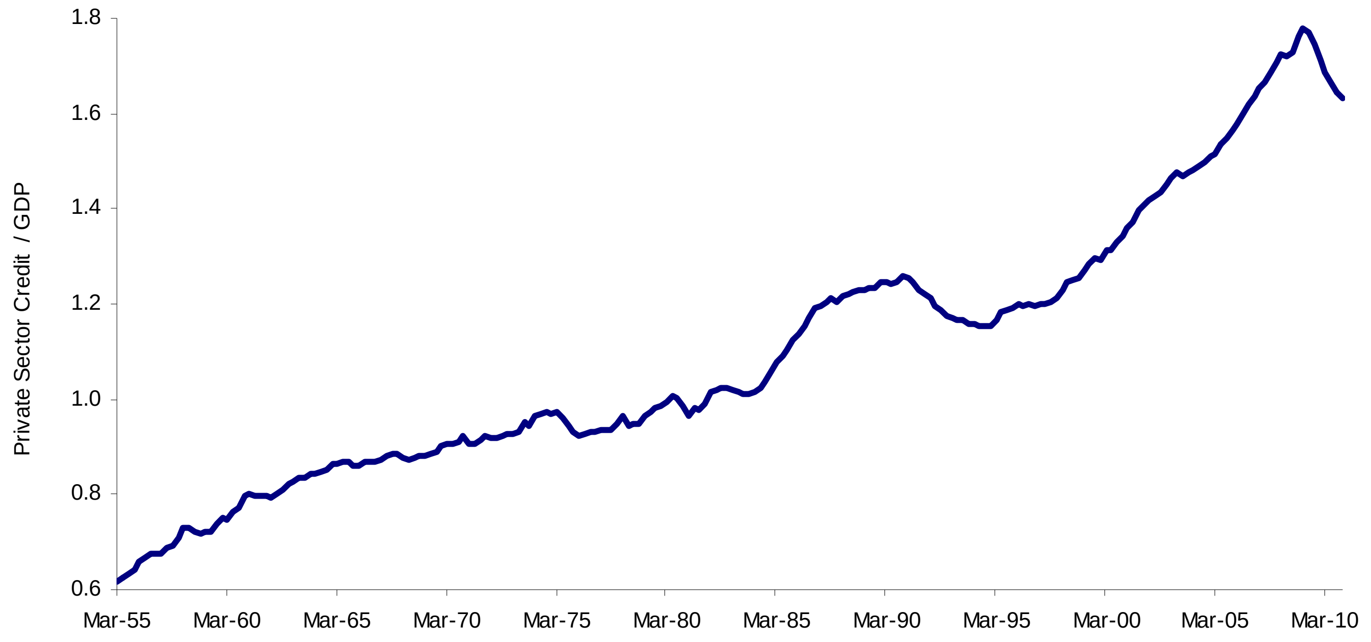
(last obs. Q1 2011)



Source: Federal Reserve; Encima Global

Deleveraging Cycle: U.S. Private Sector Credit / GDP

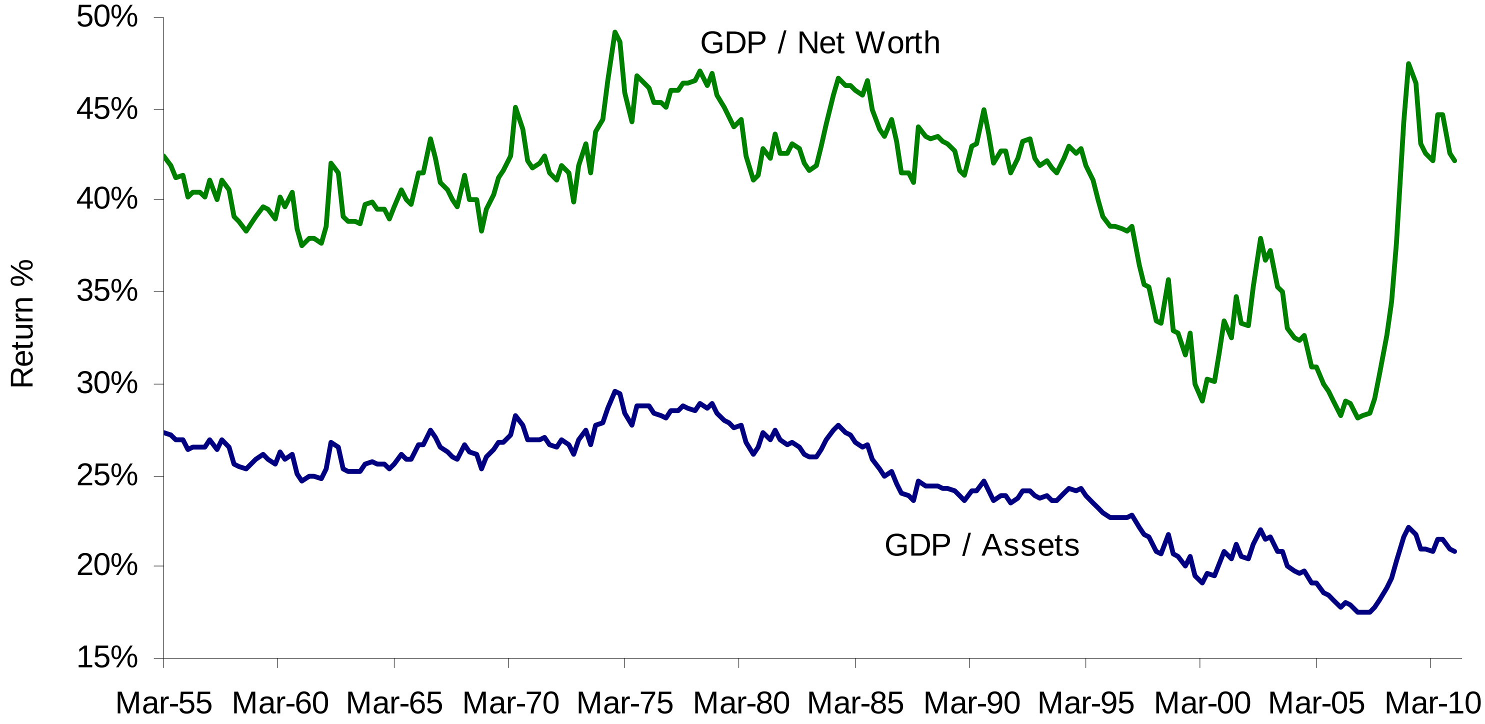
(last obs. Q1 2011)



Source: Federal Reserve; BEA; Encima Global

High Output from Net Worth and Assets

(last obs. Q1 2011)



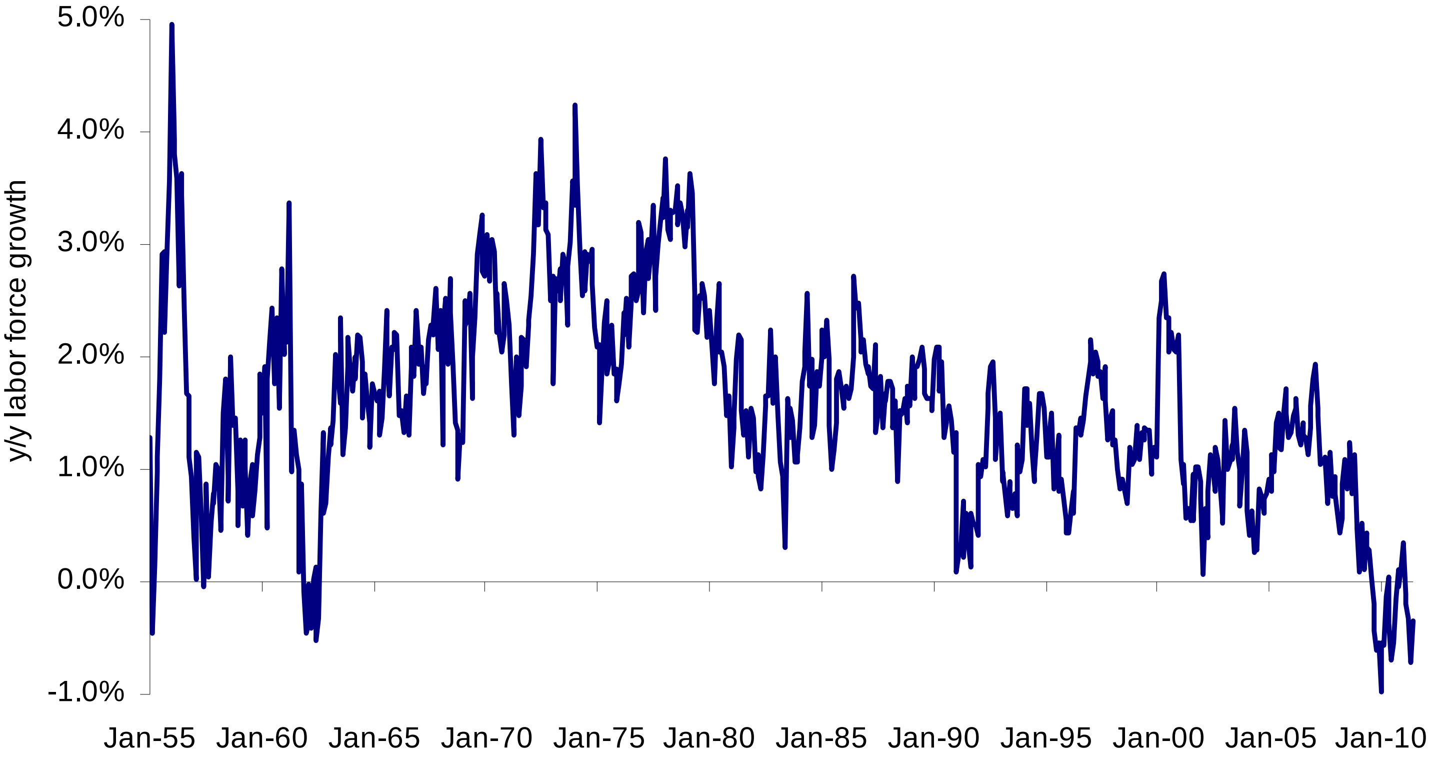
Source: Federal Reserve; BEA; Encima Global

Problems Under the Rug

- The basic U.S. policy has been to kick the can hard down the road. Contrasting with most of the rest of the world, the U.S. government has allowed unrestrained spending and mandates, with true belt-tightening still years off.
- The Federal Reserve has bought back longer-maturity debt and maintained near-zero interest rates, which hold down government and corporate borrowing costs.
- China will slow on the margin while maintaining substantial top-down control. Like the Latin debt crisis, Europe's losses on excess debt will be spread out over several years.
- Many of these policies are suboptimal or even harmful, but can-kicking and the expansion of sovereign debt will probably leave economic and market trends intact and leave room for an improvement in near-term expectations.

Expect Slower U.S. Labor Force Growth

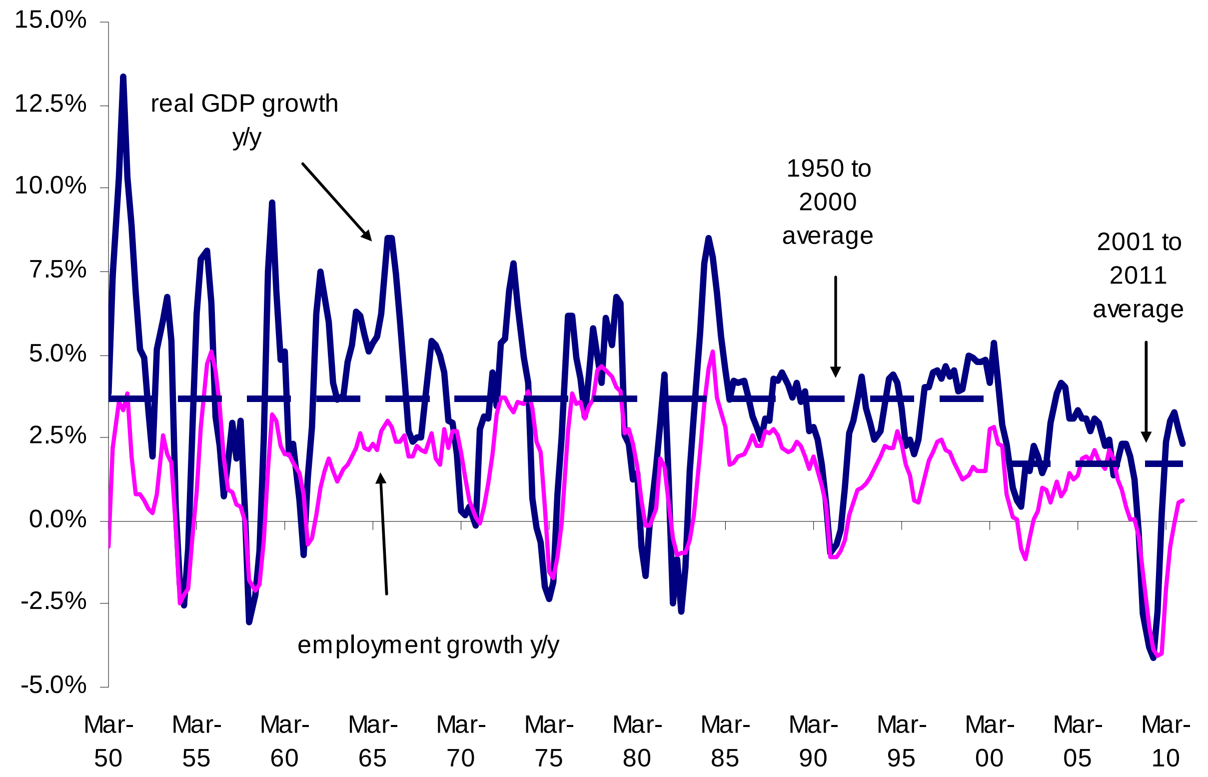
(over-16 labor force, last obs. May 2011)



Source: Bureau of Labor Statistics; Encima Global

Slower Trend GDP Growth and Employment Growth

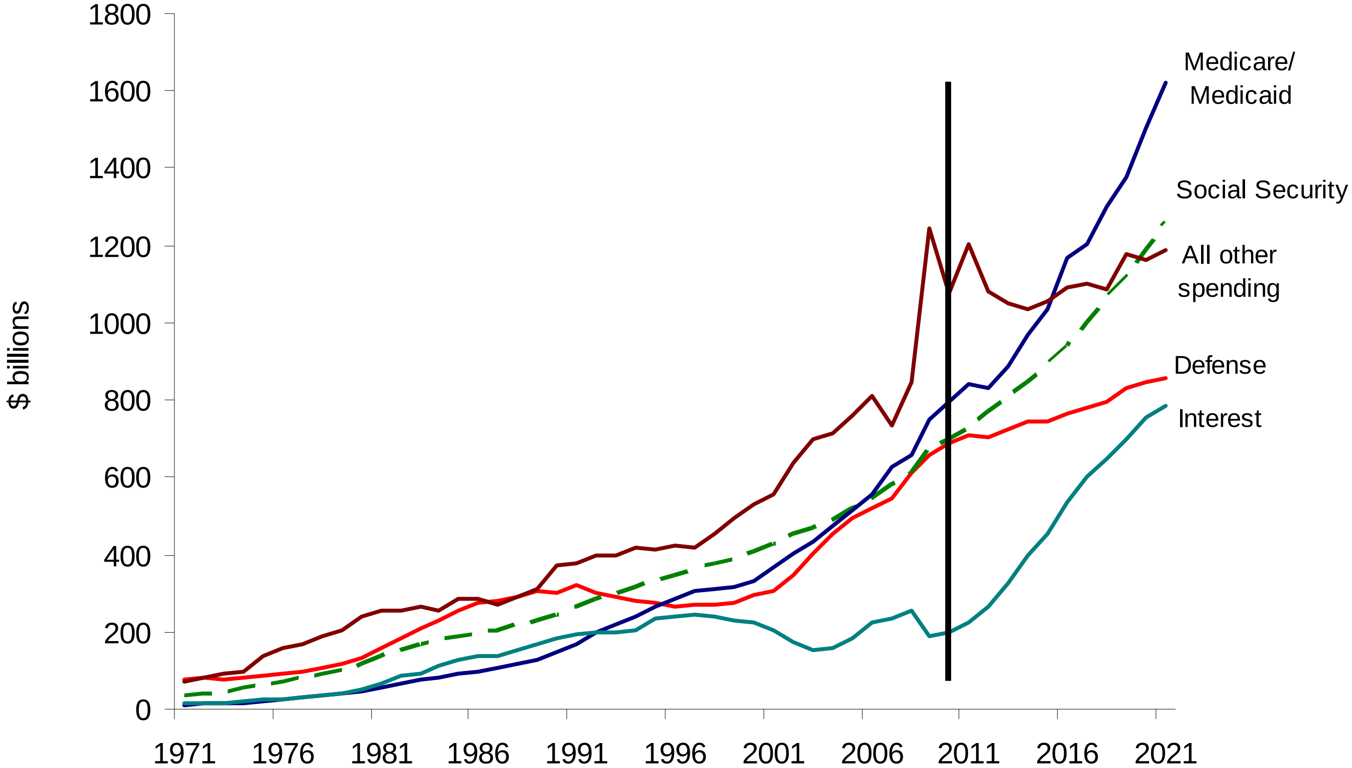
(last obs. Q1 2011)



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Encima Global

No Control on Federal Spending

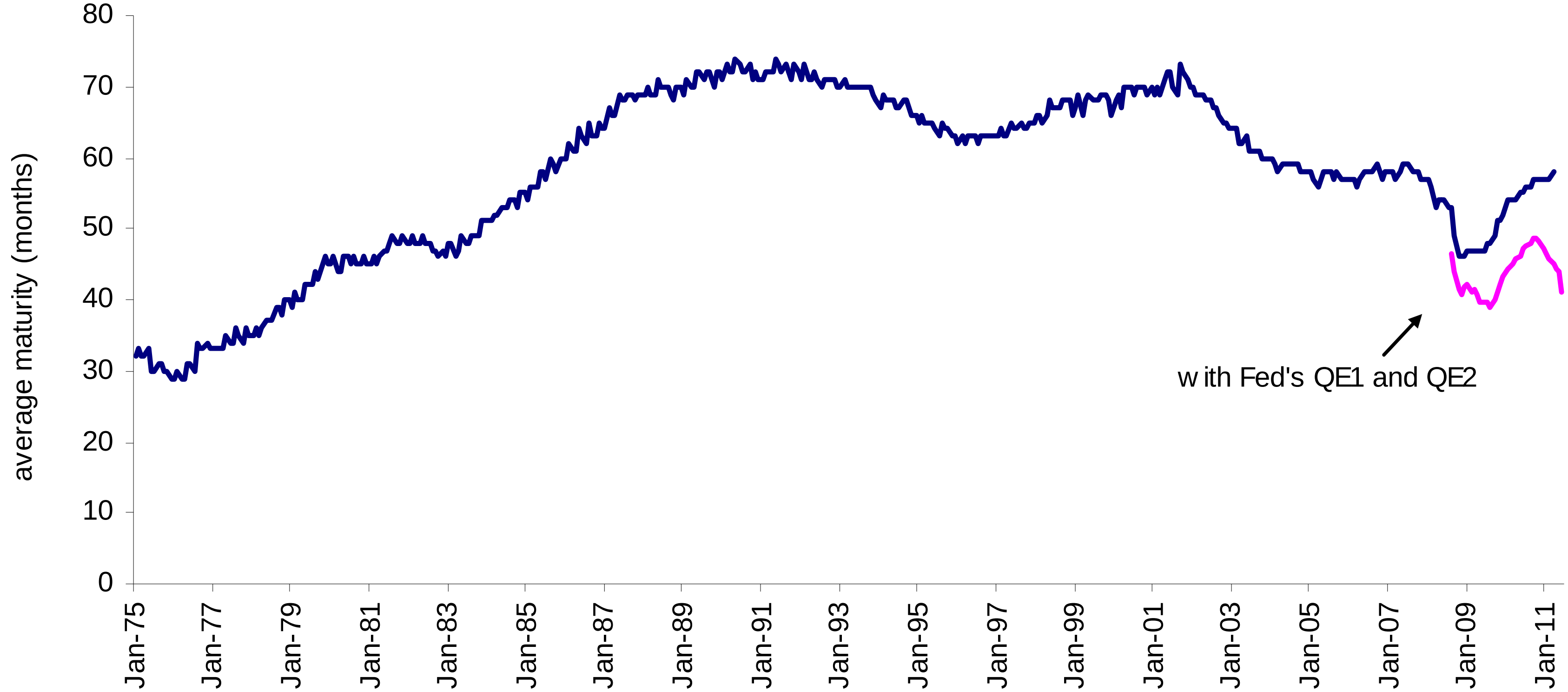
(last obs. 2010, CBO projection to 2021)



Source: CBO; Encima Global

Fed Buyback Shortened Maturity of Public Debt

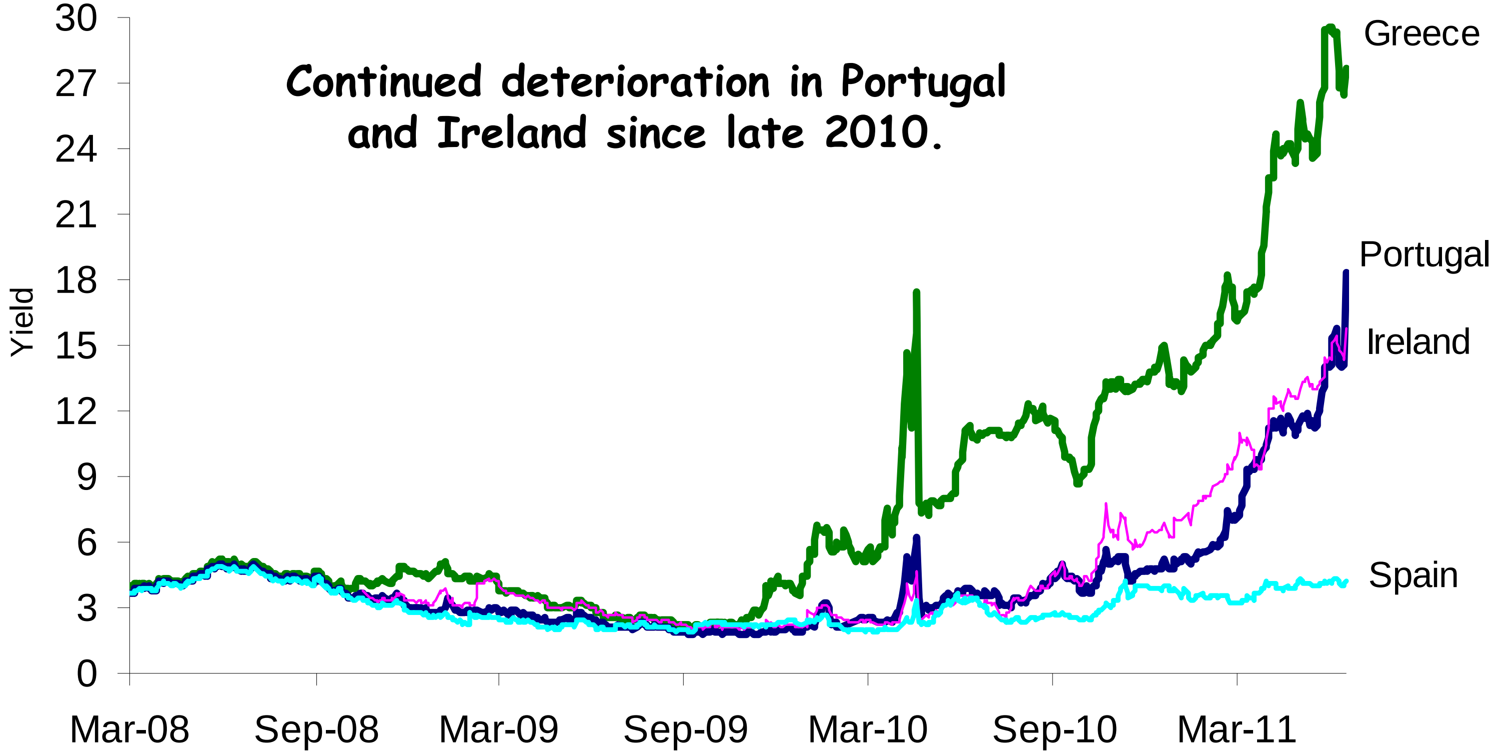
(last obs. March 2011)



Source: U.S. Treasury; Encima Global

Select European 3 Yr Yields

(last obs. July 6, 2011)



Source: Bloomberg; Encima Global

The World In 2016

- U.S. debt-to-GDP ratio 86% (now 65%) but no tipping point.
- Weak-dollar policy continues; credit pump transfers U.S. capital and investment abroad.
- U.S. share of world GDP falls; U.S. share of world investment falls much more.
- Fed funds higher; bullish as it happens; M2 growth will soar as borrowers seek loans.
- Treasury yield curve inverts over time (like in 2000 and 2006).
- Housing starts double to 800,000; major internet-sized invention <u>(guess)</u>
- Dollar weaker, gold and commodities somewhat higher; inflation averages 3.5% yoy.
- Yuan strengthens 5% per year reaching 5 per dollar (currently 6.5).
- European growth shifts north; southern Europe still in euro but decrepit waiting leaders.
- Non-bank financial services much larger and more innovative; non-U.S. earnings grow as share of corporate earnings.